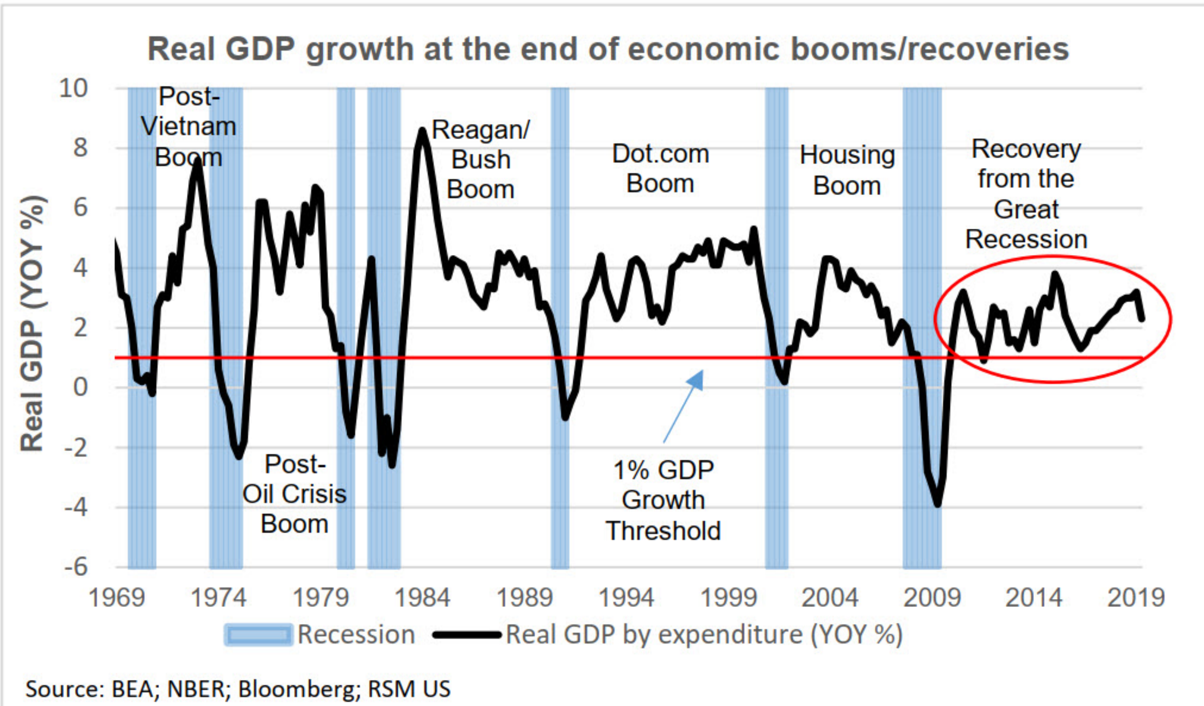
US growth decelerates amid trade uncertainty, slowing global economy

The sharp deceleration in second quarter gross domestic product (GDP) growth exaggerates the slowdown in overall economic activity, but make no mistake about it: the brief period of near 3% economic growth fueled by the 2017 Tax Cuts and Jobs Act (TCJA) has now faded. The deceleration in the economy, on a quarterly SAAR basis, to 2.1% and the slowing to 2.3% on a year-ago basis is due to the combination of the fading impact of the 2017 tax cut, a global manufacturing recession and the uncertainty tax imposed by trade policy. These factors will continue to damp growth in the second half of the year.

Dovish central bankers at the Federal Reserve now have ample evidence that monetary policy should move toward a more accommodative stance to cushion the U.S. economy from global and domestic policy headwinds.



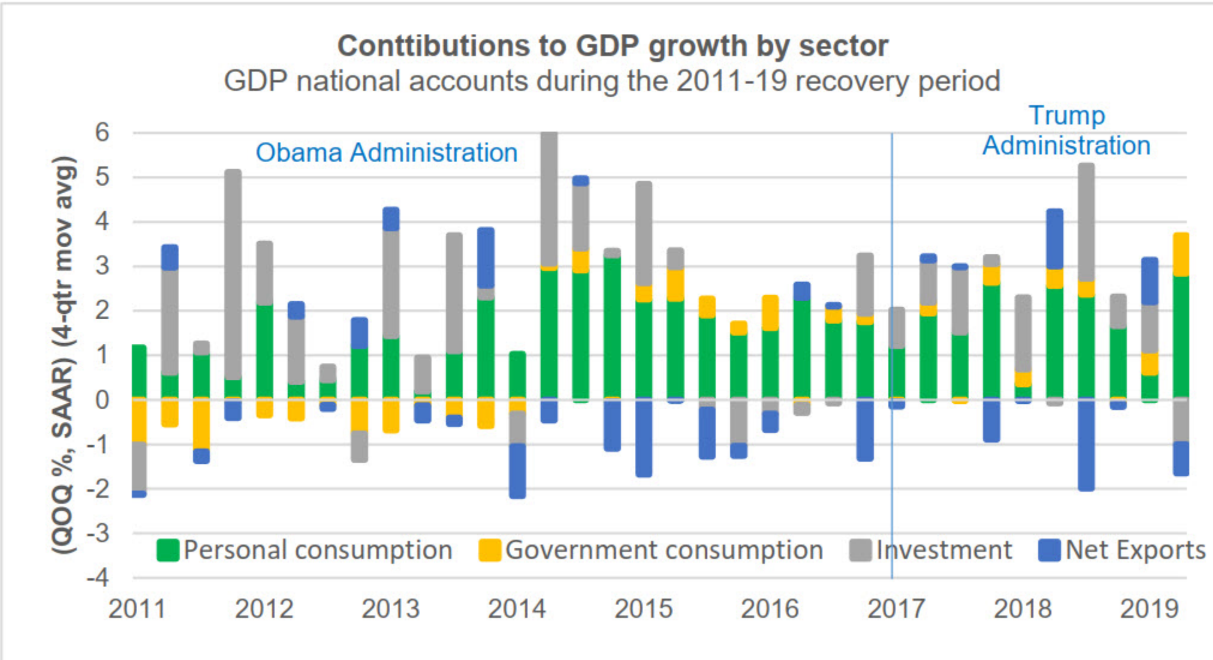
Due to the excessive noise in the data during the first half of the year (a combination of whipsaw trade policy and the government shutdown), we prefer to look at real final sales and final sales to private domestic purchasers to ascertain the condition of the real economy. The former increased at a 3% pace and averaged 2.8% in the first half of the year. Final sales to private domestic purchasers rebounded to 3.2% from an upwardly revised 1.6% and averaged 2.4% during the first six months of the year.

Household consumption in the second quarter of 2019 increased at a 4.2% pace following the tepid 1.1% expansion in the first three months of the year. However, that has to be put in context. The government shutdown, a difficult winter and the lagged impact of financial market volatility were primarily responsible for weak household output in the first quarter. Thus, the second quarter saw the release of pent-up demand and therefore does not imply a sustainable increase in household spending.

The composition of consumption supports this assessment. Outlays on durable goods increased by 12.9%, non-durable spending advanced by 6% and service sector spending increased at a 2.5% pace. In this context, it’s best to average out the first two quarters of the year, which implies a 2.65% pace of growth in household spending. This is sustainable under current economic conditions.

Fixed business investment declined by 5.5%, primarily due to a 10.6% decline in structures. Outlays on equipment rebounded from a modest decline in the first quarter and increased by 0.7%, while spending on intellectual property increased 4.7% following the torrid growth of 10.8% in the first quarter and 11.7% to close out 2018. Residential investment declined by 1.5% and is the sixth straight quarter of declining speculative real estate activity.

Exports declined by 5.2% and imports increased 0.1%. Inventory accumulation slowed to $71.1 billion from $116 billion previously. Government spending, which was one of the major drivers of growth, increased by 5%. Federal spending increased by 7.9% and state and local outlays increased by 3.2%. Outlays on national defense increased 2.8% and non-defense spending advanced a whopping 15.9%.



Policy implications

The soft second quarter GDP report underscores why the Fed is now setting up to cut the Federal Funds rate by 25 basis points on July 31. Headwinds from the global economy and the weak performance of the domestic manufacturing sector over the past several months are evidence enough that the economy has slowed. The larger question is will the Fed move to cut rates at its Sept. 18 meeting and perhaps again at the Dec. 11 meeting. Our baseline case is the Fed will likely reduce its policy rate by 25 basis points at both the September and December meetings.

Absorbing the costs

The lagged impact of the U.S. trade war with China is now hitting second quarter corporate earnings and that acted as a drag on fixed business investment. Forward guidance from BASF, Dow and Caterpillar has made it clear that the U.S. trade policy drag on growth has rolled over into the current quarter. So far in the second quarter about a third of all firms reporting earnings have blamed tariffs for disappointing outlooks. Given that the domestic manufacturing sector has only generated 45,000 jobs during the past six months, third quarter forward guidance suggests even more downside risk for hiring.

The uncertainty tax linked to trade policy will likely continue to damp fixed business investment and widen the trade deficit. This will continue to act as a drag on topline GDP growth which we expect to arrive on average of 1.8 percent in the second half of the year. The consumer has been the main engine of economic growth this year, however that should not be taken as a given going forward. As firms facing

margin compression look to try to pass along increased costs linked to tariffs downstream, our view is this may lead to slower household consumption, further limiting potential GDP growth. Consumers will see higher prices on basic goods this fall. However one views the impact of U.S. trade policy, 3% GDP growth on an annualized basis is decidedly in the rearview mirror.

One Report, two narratives
An economy growing near 1.8% that produces lower than 4% unemployment and only 2% inflation reflects an economy that has decelerated noticeably after the peak impact of the 2017 TCJA. The second quarter growth report will be interpreted by the financial sector as an expected outcome following the "sugar high" associated with the tax cuts.

The data makes one thing clear: the 2017 TCJA did not result in a permanent shift upward in the growth path of the U.S. economy. The long-term U.S. GDP growth trend remains just 1.8%. With the annual operating deficit expected to surpass $1.3 trillion this year and move toward 5.5% of GDP in 18 months, the question now is: Was it worth it?